SUPREME COURT, U. S.

FILED

SEP 28 1973

MICHAEL RODAK, JR., CLERK

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-575

ANITA B. BRODY,

Petitioner,

v.

CHEMICAL BANK, MANUFACTURERS HANOVER TRUST COMPANY, IRVING TRUST COMPANY, CHASE MANHATTAN BANK, N.A., BANK OF MONTREAL, GIRARD TRUST BANK and THE FIDELITY BANK,

Respondents,

and

PENNSYLVANIA COMPANY,

Defendant.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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September 27, 1973

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Supreme Court of the United States

OCTOBER TERM, 1973

No. .....

ANITA B. BRODY,

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CHEMICAL BANK, MANUFACTURERS HANOVER TRUST COMPANY, IRVING TRUST COMPANY, CHASE MANHATTAN BANK, N.A., BANK OF MONTREAL, GIRARD TRUST BANK and THE FIDELITY BANK,

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PENNSYLVANIA COMPANY,

Defendant.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

The petitioner, Anita B. Brody, respectfully prays that a writ of certiorari issue to review that portion of the judgment and opinion of the United States Court of Appeals for the Second Circuit entered in this proceeding on July 3, 1973 which affirmed the dismissal of the representative counts of the amended complaint for failure to state a cause of action.

Opinions Below

The opinion of the Court of Appeals, not yet reported, appears as Appendix A hereto. An opinion rendered by

the District Court of the Southern District of New York on July 26, 1972 (No. 71 Civ. 2639, unreported), appears as Appendix B hereto.

Jurisdiction

The judgment of the Court of Appeals for the Second Circuit was entered in this case on July 3, 1973. A petition by the defendants-appellees for rehearing was denied on August 2, 1973. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

Question Presented

Whether a cause of action for direct relief on behalf of the class of preferred stockholders was stated when plaintiff alleged that the wrongful acts which were the basis of a derivative cause of action on behalf of a corporation also resulted in a serious impairment of the financial structure of the corporation to the point that the preferred stockholders' investment was endangered, the corporation's ability to pay monies due to the preferred stockholders has been seriously reduced and the corporation has defaulted in the payment of dividends on the preferred stock, and where the harm to the corporation did not fall equally on all of the stockholders.

Statutory Provisions Involved

Rules of Decision Act, 28 U.S.C. §1652:

State laws as rules of decision

> "The laws of the several states, except where the Constitution or treaties of the United States or Acts of Congress otherwise require or provide, shall be regarded as rules of decision in civil actions in the courts of the United States in cases where they apply."

Statement of the Case

This action was brought in the United States District Court for the Southern District of New York by a holder of cumulative preferred stock of the nominal defendant, Pennsylvania Company ("Pennco"), derivatively on behalf of Pennco and representatively on behalf of all other Pennco preferred stockholders similarly situated. The amended complaint alleged in substance as follows:

All of Pennco's common stock is owned by Penn Central Transportation Company ("Railroad"). Its cumulative preferred stock is publicly owned. Railroad completely controlled and dominated the affairs of Pennco and determined its business decisions. Defendants Chemical Bank, Manufacturers Hanover Trust Company, Irving Trust Company, Chase Manhattan Bank, N.A., Bank of Montreal, Girard Trust Bank, and The Fidelity Bank (herein collectively, the "Defendant Banks" or "Defendants"), unwilling to lend monies to Railroad because of its bad financial condition, conspired with Railroad, (1) to cause Pennco to enter into a transaction with Defendant Banks pursuant to which Pennco borrowed $50,000,000 in exchange for Pennco's notes; (2) to cause Pennco to turn these funds over to Railroad in return for notes of Railroad which were then, or would shortly become, almost worthless, as Defendant Banks knew; and (3) accordingly to use Pennco as a conduit by which to achieve Defendants' purpose of providing these funds to Railroad; all to the damage of Pennco and its preferred stockholders and to the benefit of Defendant Banks and Railroad.

Specifically, the derivative claims of the amended complaint set forth that Railroad had been in a precarious financial condition for more than a year and a half. It had a loss of more than $56,000,000 in 1969, and a loss of

$62,700,000 in the first quarter of 1970. On June 20, 1970, Railroad filed a petition under Section 77 of the Federal Bankruptcy Act.

Sometime in or about early 1970, Railroad disclosed its dire financial situation to Defendant Banks, showing them confidential projections of its dismal financial future, and informing them of its critical need for funds. The information thus disclosed to Defendant Banks was not yet available to the public. Railroad requested a loan from said Banks, but they refused to lend funds directly to Railroad.

Thereupon Defendant Banks and Railroad conspired together to cause Pennco and did cause Pennco in or about May of 1970 to borrow $50,000,000 from Defendant Banks in exchange for Pennco's note and to transfer the proceeds of such borrowing to Railroad, either directly or through one of Railroad's subsidiaries, in exchange for worthless notes. The aforesaid borrowing was not intended to serve and did not serve any proper business or corporate purpose of Pennco. The terms of the loan were negotiated by representatives of Railroad with the Banks, without participation by any representative of Pennco.

The Defendant Banks knew or had reason to know that at the time of the loan transaction Railroad controlled Pennco, that Railroad's directors were also directors of Pennco, that Railroad was compelling Pennco to borrow said $50,000,000, that Railroad was the intended recipient of the loan, that Railroad gave Pennco no fair or adequate consideration for the funds turned over by Pennco to Railroad, and that Railroad was incapable of repaying said funds to Pennco.

The foregoing transfer of $50,000,000 by Defendant Banks to Railroad through Pennco violated Section 17(a) of the Securities Act of 1933 and constituted common law fraud.

As relief, plaintiff seeks to rescind the loan agreement, compel the Defendant Banks to return Pennco's notes to it for cancellation and declare these notes void upon Pennco's delivery to the Defendant Banks of Railroad's $50,000,000 notes, and to obtain for Pennco compensatory damages and recovery of the profits made by Defendant Banks and Railroad, plus exemplary damages.

The representative claims alleged on behalf of plaintiff and all other preferred stockholders of Pennco similarly situated were contained in paragraph 47 of the amended complaint which stated as follows:

> "47. As a result of said transactions, Pennco's financial structure has been seriously impaired to the point where the investment of the preferred stockholders in Pennco is endangered, Pennco's ability to pay monies due to the preferred stockholders, and the market price of the preferred stock, have been substantially reduced, and Pennco has, in fact, failed to pay dividend income due to the preferred stockholders."

By their acts the Defendant Banks defrauded the preferred stockholders of Pennco to the substantial and unjust enrichment of the Banks and caused substantial damage to Pennco's preferred stockholders.

Plaintiff, on behalf of the preferred Pennco stockholders, demanded judgment against the Defendant Banks and in favor of the preferred stockholders for the amount of all damages sustained by them, plus exemplary damages.

Judge Gagliardi in the District Court for the Southern District of New York granted a motion to dismiss the first and third counts of the amended complaint (the derivative counts) and the fifth and sixth counts (the representative

counts), the latter for failure to state a cause of action for which direct relief can be granted.*

Petitioner's appeal from Judge Gagliardi's order of dismissal was argued on June 4, 1973 before a panel of the Court of Appeals for the Second Circuit consisting of Judges Hays, Mansfield and Mulligan. The Court of Appeals in a per curiam opinion affirmed the dismissal of the representative counts and remanded the remaining counts to the court below with permission to the plaintiff to replead in compliance with Fed. Rules Civ. P. 23.1.

Reasons for Granting the Writ

I

By Its Decision Sustaining the Dismissal of the Representative Counts, the Court of Appeals Has Disregarded Prior Decisions of This Court and Has Taken a Position in Conflict With the Courts of Appeals for the Fifth Circuit and Seventh Circuit.

This Court has decided that the same set of facts can give rise to a derivative and a representative cause of action. In *J. I. Case Company* v. *Borak,* 377 U.S. 426 (1964), this Court stated (p. 431) that a right of action based on a deceptive proxy solicitation "exists as to both derivative and direct causes" despite the Court's recognition that

> "[t]he injury which a stockholder suffers from corporate action pursuant to a deceptive proxy solicitation ordinarily flows from the damage done to the corporation rather than from the damage inflicted directly

* The second and fourth counts of the amended complaint were discontinued without prejudice by stipulation of the parties.

upon the stockholder. The damage suffered results not from the deceit practiced on him alone but rather from the deceit practiced on the stockholders as a group." 377 U.S. at 432.

The Court of Appeals for the Seventh Circuit, in *Borak* v. *J. I. Case Company*, 317 F.2d 838 (7th Cir. 1963), had reversed the District Court's ruling, finding that the District Court had "failed to recognize the principle that the same allegations of fact might support either a derivative suit or an individual cause of action by shareholders." 317 F.2d at 845. The Court of Appeals pointed out that the realities of the situation required the recognition of the existence of two classes of stockholders, those who benefited by the alleged wrongful acts and those who did not.

The ruling of the Court of Appeals for the Second Circuit in the instant case is also in direct conflict with that of the Fifth Circuit, as set forth in an opinion by Justice Tom Clark, Associate Justice, United States Supreme Court (Retired) sitting by designation, in *Spalitta* v. *National American Bank of New Orleans*, 444 F.2d 291 (5th Cir. 1971), cert. denied 404 U.S. 883 (1971). The gist of the complaint in that case was that defendant bank, of which the appellant was a stockholder, had suffered substantial losses because of certain fraudulent and illegal acts and transactions by its officers and directors in breach of their fiduciary responsibility. The action was brought as a derivative and class action based on violations of the National Banking Act.

The appellate court stated its agreement with the trial court that the appellant had standing to sue on the class action as well as on the derivative action, although the appellant was seeking damages for the defendant bank against certain of its officers.

In addition to its ruling permitting both a derivative and class suit on the same set of facts, the Court of Appeals for the Fifth Circuit cited a further principle which had been enunciated by this Court and which was disregarded by the Court of Appeals for the Second Circuit in dismissing the representative counts in the instant case, a principle which is peculiarly applicable to this case which charges a fraud involving $50,000,000. This principle, set forth in *Surowitz* v. *Hilton Hotels Corp.*, 383 U.S. 363 (1966), is as follows:

> "We cannot construe Rule 23 or any other one of the Federal Rules as compelling courts to summarily dismiss, without any answer or argument at all, cases like this where grave charges of fraud are shown by the record to be based on reasonable beliefs growing out of careful investigation." 383 U.S. at 373.

On the question of damages to the class, as distinct from damages to the corporation, it should be noted that while the Court of Appeals for the Seventh Circuit in *Borak* v. *J. I. Case Company, supra,* described the harmful result to the stockholders in the second group as a dilution of their proportionate interests in the corporation, there was no intimation that its finding was limited only to situations in which such a dilution occurred. Nor did this Court in its determination, in *J. I. Case Company* v. *Borak, supra,* that a proxy solicitation violation can create both a representative and a derivative cause of action, limit its ruling to situations where the damage involved a dilution of stockholders' interests. A similar ruling is compelled in any situation where, while damage is done to the corporation, particular damage is done to one category of stockholders, rather than to all stockholders in equal degree.

In the instant case, the damage to the corporation is clear, but in addition, as in *Borak,* the stockholders must be divided into two categories, the owner of the common stock (Railroad), which benefited from the wrongdoing, and the preferred stockholders, who did not participate in the benefits but whose interests were damaged, not only secondarily because of the damage to the corporation but directly in the manner set forth in paragraph 47 of the amended complaint.

The damage of which plaintiff complained is not that described in the opinion of the District Court which was the basis for the affirmance by the Court of Appeals for the Second Circuit of the dismissal of the representative counts (App. 3a). The District Court in its opinion limited plaintiff's contentions to the following:

> ". . . that as a result of the loan transaction, the market price of Pennco stock has been substantially reduced, and that Pennco has been unable to pay dividends." (App. 14a)

and referred later to "subsequent injury to the shareholders by virtue of a diminution in the value of corporate stock" (App. 15a) as though these were the only elements of damage which plaintiff alleged her class had suffered.

The District Court completely disregarded plaintiff's allegation of the impairment of Pennco's financial structure to the point where the investment of the preferred stockholders was endangered, and transformed her complaint about the *inability* of Pennco to pay dividends into a complaint that "Pennco has failed to pay dividends, thereby directly injuring the shareholders." (App. 15a). The court then proceeded to deal with the right of a shareholder to compel the declaration of a dividend, describing it as "at best tenuous," as though plaintiff was claiming

the right to compel the declaration of a dividend. Plaintiff was not suing to compel the payment of dividends. Plaintiff's statement that Pennco had failed to pay dividends was no more than a description of one of the effects of the wrongful acts of which she complained.

Since what is involved here is a dismissal of the representative counts on the ground that they fail to state a claim upon which relief can be granted, not only must the facts which are well-pleaded be accepted as true and resolved in the light most favorable to the pleader, *Spalitta* v. *National American Bank of New Orleans, supra,* but before the dismissal can be sustained, the Court must conclude that plaintiff could prove no facts entitling her to relief. (*Conley* v. *Gibson,* 355 U.S. 41, 45-48 (1957).

The amended complaint contains sufficient well-pleaded allegations to show serious damage to the class of which plaintiff is a member, the damage consisting not only of the danger to the preferred stockholders' investment, but the reduction of Pennco's ability to pay dividends. We note that even if the dividends will eventually be paid, there will be a substantial loss in interest to the preferred stockholders due to the delay in payment.

II

The Court of Appeals for the Second Circuit, in Its Decision Sustaining the Dismissal of the Representative Counts, Disregarded New York State Common Law.

The representative counts of the amended complaint are grounded in common law, with federal jurisdiction resting on the principles of pendent jurisdiction (the fifth count) and diversity (the sixth count). Under the Rules of Decision Act, 28 U.S.C. § 1652, and *Erie R. Co.* v. *Tompkins*, 304 U.S. 64 (1938), the Court of Appeals was required to apply New York State common law to the question of the propriety of the dismissal by the District Court of the representative counts.

The courts of New York State have repeatedly held that the same acts which give rise to a derivative action on behalf of a corporation can also give rise to an action on behalf of individual stockholders if they have been separately damaged.

The principle was explicitly stated in *Hammer* v. *Werner*, 239 App. Div. 38, 265 N.Y.S. 172 (2nd Dept. 1933), as follows:

> "The fact that a particular act of directors may constitute a wrong to the corporation which may be righted ordinarily on behalf of the corporation does not bar a stockholder from having redress if that act effects a separate and distinct wrong to him independently of the wrong to the corporation. Redress of this latter wrong is available to him personally despite the right of a present stockholder to redress the wrong in a derivative action so far as it relates to the corporation. (Von Au v. Magenheimer, 126 App. Div. 257, affirmed 196 N.Y. 510; Ritchie v. McMullen, 79

Fed. 522; Rothmiller v. Stein, 143 N.Y. 581." 239 App. Div. at 44, 265 N.Y.S. at 179.

The complaint in *Hammer* v. *Werner, supra*, alleged not only that two directors had acquired a block of its stock from the company at an inadequate price (a derivative wrong) but that by this acquisition they inequitably increased their proportionate vote in the affairs of the company (thus directly adversely affecting the rights of plaintiff as a stockholder).

In *Kono* v. *Roeth*, 237 App. Div. 252, 260 N.Y.S. 662, 664 (1st Dept. 1932), the gist of the complaint was that the defendants conspired to render worthless plaintiff's stock in a corporation, which stock was pledged for a loan, by various acts which caused the corporation to be wrongfully and fraudulently destroyed. The lower court had concluded that plaintiff (an ancillary administrator of the estate which owned the stock) was relegated to a derivative cause of action based upon the wrongs done to the corporation. The Appellate Division disagreed on the ground that an unlawful act which caused depreciation of the stock of a corporation by injury to the corporate assets may not only form the basis of a derivative action, "but upon such acts may be predicated, in a proper case, an individual cause of action by one having a property right or interest in such stock." 237 App. Div. at 255, 260 N.Y.S. at 664.

In *Witherbee* v. *Bowles*, 201 N.Y. 427, 95 N.E. 27 (1911), the New York Court of Appeals enunciated the same principle, saying that

> "It is not questioned that these acts might be made the basis of an action by or in behalf of the corporation to remedy the injury inflicted upon it and through it upon all of the stockholders in common. But these

> same acts performed for the purpose and with the effect stated worked an injury to rights belonging to the plaintiffs individually as between them and the corporation and its other stockholders and not common to the latter." 201 N.Y. at 431, 95 N.E. at 28.

It sustained the rights of the plaintiffs to sue in their individual capacity rather than derivatively.

III

The Importance of the Issues.

The decision of the Court of Appeals for the Second Circuit affirming the dismissal of the representative counts of the amended complaint represents a departure from the policy of protection of the rights of minority stockholders against the wrongdoing of controlling stockholders and those acting in concert with such controlling stockholders. It creates a conflict with the decisions of the Courts of Appeals in other circuits and disregards the policies established by decisions of this Court in the area of stockholders' rights. It fails to adhere to the requirements established by *Erie R. Co.* v. *Tompkins, supra,* in its failure to apply New York State common law to the issue before it. If not corrected by this Court, the holding below will create confusion in an important area of stockholder rights and reverse the trend toward increased protection for such rights.

CONCLUSION

For the reasons set forth above, this petition for a writ of certiorari should be granted and that portion of the judgment of the Court of Appeals for the Second Circuit affirming the dismissal of the representative counts of plaintiff's amended complaint should be reversed.

Respectfully submitted,

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September 27, 1973

APPENDICES

APPENDIX A

Opinion of the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 812—September Term, 1972.

(Argued June 4, 1973 Decided July 3, 1973.)

Docket No. 72-2047

ANITA B. BRODY,

Plaintiff-Appellant,

—against—

CHEMICAL BANK, MANUFACTURERS HANOVER TRUST COMPANY, IRVING TRUST COMPANY, CHASE MANHATTAN BANK, N.A., BANK OF MONTREAL, GIRARD TRUST BANK and THE FIDELITY BANK,

Defendants-Appellees,

—and—

PENNSYLVANIA COMPANY,

Defendant.

Before:

HAYS, MANSFIELD and MULLIGAN,

Circuit Judges.

Appeal from a judgment of the United States District Court for the Southern District of New York, Lee P.

Gagliardi, *Judge*, dismissing representative and derivative claims of preferred corporate shareholder.

Affirmed in part and remanded.

PER CURIAM:

This is an appeal from a judgment of the United States District Court for the Southern District of New York, Hon. Lee P. Gagliardi, entered on August 3, 1972, dismissing finally an amended complaint. The complaint by a preferred stockholder of the Pennsylvania Company (Pennco) was brought derivatively on behalf of Pennco and representatively on behalf of all other Pennco stockholders similarly situated. Plaintiff alleges that the defendants Chemical Bank, Manufacturers Hanover Trust Company, Irving Trust Company, Chase Manhattan Bank, N.A., Bank of Montreal, Girard Trust Bank, and the Fidelity Bank (Banks) were unwilling to lend money to the Penn Central Transportation Company (Railroad) because of its weak financial condition. It is further alleged that the Banks conspired with the Railroad which held all of Pennco's outstanding common stock, to cause Pennco to enter into an arrangement whereby Pennco borrowed $50,000,000 from the Banks in return for the note of the solvent Pennco. The funds were then turned over to the Railroad in return for the Railroad's notes to Pennco which were or soon would be, to the knowledge of the Banks, practically worthless. The complaint states that the Pennco loan was made in May 1970 when the Banks had already refused to make a loan to the Railroad in view of its staggering losses in 1969 and the first quarter of 1970. On June 20, 1970 the Railroad filed a petition under § 77 of the Federal Bankruptcy Act. The plaintiff

urges that the transfer of the $50,000,000 in this fashion constituted common law fraud as well as a violation of § 17(a) of the Securities Act of 1933 (15 U.S.C. § 77q(a)).

The defendants moved to dismiss the representative counts for failure to state a cause of action. The dismissal of the representative action by the court below was based on a finding that the injury here was not uniquely to the preferred stockholders of Pennco but to the corporation which has the remedy of either a direct action or a derivative suit brought on its behalf. We affirm the dismissal of these counts on the opinion below (*Brody* v. *Chemical Bank*, Docket No. 71 Civ. 2639, at 10-14 (S.D.N.Y. July 26, 1972)).

The motion for dismissal of the derivative counts was bottomed upon the argument that the complaint violated Fed. R. Civ. P. 23.1 which requires in pertinent part:

> The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort.

The plaintiff admittedly did not make a demand on the board of directors of Pennco nor its common stockholder before commencing the action. The plaintiff instead simply pleaded:

> Plaintiff has made no demand on the Board of Directors of Pennco to take action with regard to the wrongs herein described because all of said directors are designees of Railroad which, through its ownership of all of Pennco's common stock, has been able

> **to designate and select said directors. Railroad, by said stock ownership, controls Pennco and said directors. Thus, to make demand upon said directors would be to request that they sue the company that has chosen them and that controls them. By reason of the foregoing, any demand upon said Board of Directors to redress or prevent the wrongs herein described would have been futile.**

Inasmuch as four trustees have been appointed for the bankrupt Railroad and since they in turn have selected a new board of four directors for Pennco, we cannot disagree with the court below that the allegations of the complaint are insufficient to excuse plaintiff's failure to make a demand on the Pennco board. Plaintiff then sought discovery to establish that there was an interrelationship between the new Pennco board and the pre-bankruptcy management of the Railroad. The court below held that even arguendo such link did exist, a demand upon the common stockholder was necessary in any event, and there was no showing that such a demand would be futile since the Railroad trustees were court appointed and not implicated in the transaction which is the basis for the complaint herein. However, it is settled that the federal courts will look to the state law in such cases to determine whether a demand on stockholders is necessary. *Gottesman* v. *General Motors Corp.*, 268 F.2d 194, 197 (2d Cir. 1959); *Dopp* v. *American Elec. Labs. Inc.*, 55 F.R.D. 151, 155 n.10 (S.D.N.Y. 1972). Railroad is a Delaware corporation and the leading Delaware case in point, *Mayer* v. *Adams*, 37 Del. Ch. 298, 141 A.2d 458 (Sup. Ct. Del. 1958), holds that a shareholder demand is unnecessary where the wrongs complained of (fraud) are beyond the power of ratification by a majority of the

stockholders. While the Delaware point of law was not raised below, there is no reason why this court should not consider it here. *American Sur. Co.* v. *Coblentz*, 381 F.2d 185, 189 n.5 (5th Cir. 1967); *Bartlett-Collins Co.* v. *Surinam Navigation Co.*, 381 F.2d 546, 550 (10th Cir. 1967). In view of the gravity of the alleged wrongdoing we cannot agree with the final dismissal and therefore remand. The plaintiff then may either make a demand on the directors or not, as she chooses. In any event, the repleading must comply with Rule 23.1. See *In re Kauffmann Mutual Fund*, CCH Fed. Sec. L. Rep. ¶93,987, at 93,975 (1st Cir. May 14, 1973); 7A Wright & Miller, Federal Practice and Procedure: Civil § 1832, at 392 (1972). After pleading in compliance with Rule 23.1 the question of whether or not discovery should be permitted rests in the discretion of the trial court (see *Fifth Ave. Peace Parade Comm.* v. *Gray*, slip op. 4187, 4200 (2d Cir. June 12, 1973)), which did not reach this issue since it proceeded on the erroneous theory that in any event stockholder demand was necessary.

Affirmed in part and remanded.

Judgment of the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the third day of July one thousand nine hundred and seventy-three.

Present:

HON. PAUL R. HAYS,
HON. WALTER R. MANSFIELD,
HON. WILLIAM H. MULLIGAN,

Circuit Judges.

72-2047

ANITA B. BRODY,

Plaintiff-Appellant,

v.

CHEMICAL BANK, MANUFACTURERS HANOVER TRUST COMPANY, IRVING TRUST COMPANY, CHASE MANHATTAN BANK, N.A., BANK OF MONTREAL, GIRARD TRUST BANK, THE FIDELITY BANK, MELLON NATIONAL BANK & TRUST COMPANY, PITTSBURGH NATIONAL BANK, NATIONAL BOULEVARD BANK OF CHICAGO and PENNSYLVANIA COMPANY,

Defendants-Appellees.

Appeal from the United States District Court for the Southern District of New York.

Judgment of the Court of Appeals

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order and judgment of said District Court be and they hereby are affirmed in part and that the action be and it hereby is remanded to said District Court for further proceedings in accordance with the opinion of this court.

A. Daniel Fusaro
Clerk

APPENDIX B

Opinion and Judgment of the District Court

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

71 Civ. 2639

ANITA B. BRODY,

Plaintiff,

—against—

CHEMICAL BANK, MANUFACTURERS HANOVER TRUST COMPANY, IRVING TRUST COMPANY, CHASE MANHATTAN BANK, N.A., BANK OF MONTREAL, GIRARD TRUST BANK, THE FIDELITY BANK, MELLON NATIONAL BANK & TRUST COMPANY, PITTSBURGH NATIONAL BANK, NATIONAL BOULEVARD BANK OF CHICAGO and PENNSYLVANIA COMPANY,

Defendants.

GAGLIARDI, D. J.

Plaintiff, Anita B. Brody, instituted this action both derivatively, on behalf of the Pennsylvania Company (hereinafter called "Pennco") and representatively, on behalf of herself and all other shareholders of Pennco to invalidate a $50,000,000 loan by Pennco to Penn Central Transportation Company (hereinafter called "Railroad") and loans in a like amount by defendant banks to Pennco. The plaintiff asserts that these loans were made in violation of §17(a) of the Securities Act of 1933 and §20(a)(2) of the Interstate Commerce Act and as the result of a common law fraud upon Pennco. Defendants move to dismiss the

first and third counts of the complaint (the derivative counts) for failure to make a demand upon Pennco as required by Rule 23.1 Fed. R. Civ. P. and to dismiss the fifth and sixth counts (the representative counts) for failure to state a cause of action for which plaintiff can be granted direct relief.[1] Defendants put forth several alternative grounds for dismissing each individual count,[2] however, having decided that the defendants' motion may be disposed of on the grounds stated above, we do not reach these alternative grounds.

I. The Derivative Counts

Rule 23.1 Fed. R. Civ. P. sets forth the boundaries within which a shareholders' derivative action may be prosecuted. Included in the Rule is a requirement that the complaint in a derivative suit state with particularity the efforts made to obtain the desired action from the board of directors. Where such efforts have not been made, the Rule requires a detailed statement of the reasons excusing the requisite demand.

This requirement is designed to prevent the unrestrained interference of shareholders in the internal operation of the corporation and to preserve the discretion of the board of directors in prosecuting corporate claims. *United Copper Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261 (1917);

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[1] The second and fourth counts of the complaint have been discontinued without prejudice by a stipulation among the parties and consequently are not before the court on this motion.

[2] Count 1 on the ground that the acts complained of are not proscribed by the Securities Act of 1933. Counts 1, 3, 5 and 6 on the ground that the acts complained of are not tortious. Counts 1 and 5 for lack of pendent or subject matter jurisdiction. Count 3 for failure to join an indispensable party who, if properly joined, would destroy diversity of citizenship jurisdiction.

Koral v. *Savory, Inc.*, 276 N.Y. 215, 11 N.E.2d 883 (1937). However, where it is demonstrated that the board of directors is not in a position to exercise unfettered and unprejudiced judgment with respect to the propriety of the proposed action, the Rule provides that the requirement of a demand may be dispensed with as futile and meaningless, *see, e.g., Cathedral Estates* v. *Taft Realty Corp.*, 228 F.2d 85 (2d Cir. 1955); *Kaminsky* v. *Abrams*, 281 F. Supp. 501 (S.D.N.Y. 1968).

In the case before the court, the plaintiff admits the failure to make a demand but contends that under the circumstances of the instant litigation a demand would be an empty formality. Plaintiff claims that the entire Pennco board of directors is composed of designees of the Railroad and that, therefore, "to make [a] demand upon said directors would be to request that they sue the company that has chosen and that controls them." (Complaint ¶26) Moreover, plaintiff asserts that a demand upon the shareholders would be equally futile because all of the voting stock of Pennco is owned by the Railroad. The seeming logic of plaintiff's argument is, however, woven from but a few carefully selected threads; when the entire tapestry of events is examined, it becomes apparent that there is no factual basis for plaintiff's conclusion that a demand would be futile.

In June of 1970, shortly after the consummation of the Pennco-Railroad loan, the Railroad filed for reorganization in bankruptcy. Although the existence of a causal relationship between the bankruptcy with its concomitant effect on the security of the Pennco-Railroad loan and the commencement of the instant lawsuit is a matter of speculation, one indisputable and relevant result of the bankruptcy was the appointment of four trustees charged with the respon-

sibility of managing the affairs of the Railroad. Among the assets that devolved upon the trustees was all of the voting stock of Pennco, and consequently control of Pennco itself.

In the period between the appointment of the trustees and the filing of the complaint in this action, a new Pennco Board of Directors took office.[3] Under these circumstances, defendants contend that the plaintiff's allegations that a demand would be futile are unfounded. Neither the trustees of the Railroad nor the current directors of Pennco were in office at the time of the allegedly fraudulent loans. In light of these facts, defendants argue that there is no reason to believe that either the trustees or the directors would wrongfully assert their "control" over Pennco to prevent the institution of this action; and that, therefore, the allegations of the complaint are insufficient to excuse plaintiff's failure to make a demand. We agree.

As a general rule, a demand will be excused where the directors involved in the alleged misconduct constitute a majority of the board, or where the board is dominated by an alleged wrongdoer, *e.g., Meltzer* v. *Atlantic Research Corp.*, 330 F.2d 946 (4th Cir.), *cert. denied sub nom., Sloan* v. *Meltzer,* 379 U.S. 841 (1964); *Heilbrunn* v. *Hanover Equities Corp.,* 259 F. Supp. 936 (S.D.N.Y. 1966); *Crafts-*

[3] Alfred W. Martinelli, Senior Vice President and Administrative Officer, Pennsylvania Company—director as of November 19, 1970; John H. McArthur, Associate Dean and Professor, Harvard Graduate School of Business Administration—director as of September 23, 1970; Victor H. Palmieri, President and Chief Executive Officer, Pennsylvania Company and Great Southwest Corporation—director as of October 22, 1970; George K. Whitney, Retired Managing Trustee, Massachusetts Investment Trust, Consultant to Massachusetts Financial Services, Inc., Honorary Chairman of the Board, Transportation Association of America—director as of October 22, 1970.

man Finance & Mortgage Co. v. *Brown,* 64 F. Supp. 168 (S.D.N.Y. 1945). However, the rationale on which this rule is based is vitiated where the alleged malefactors are replaced by a new board prior to the institution of the derivative suit, see *Corey* v. *Independant Ice Co.,* 207 F. 459 (D. Mass. 1913); 3B J. Moore, *Federal Practice,* ¶23.1.19 at 252, or where, as in the case before the court, control of the corporation passes into the hands of trustees appointed as a result of bankruptcy or reorganization. *Lucking* v. *Delano,* 117 F.2d 159 (6th Cir. 1941); *Long* v. *Stites,* 88 F.2d 554 (6th Cir.), *cert. denied,* 301 U.S. 706 (1937); *Wachsman* v. *Tobacco Products Corp.,* 42 F. Supp. 174 (D.N.J. 1941), *aff'd,* 129 F.2d 815 (3d Cir. 1942). *See generally* 13 W. Fletcher, *Corporations* §5966 (Perm. ed. 1970); 3B J. Moore Federal Practice, §23.1.19 at 257. In sum, there is no basis for plaintiff's assumption that the current Pennco Board would wrongfully refuse to prosecute this action.

Plaintiff argues that, in the event that the court is not convinced of the sufficiency of the allegations of the complant, additional discovery should be permitted to determine the exact composition of the Pennco Board at the time this action was commenced. In response to the court's inquiry as to the scope of the intended discovery and the relevance of the information sought, plaintiff presented the court with a series of questions directed at establishing an interrelationship between the current Pennco Board and the pre-bankruptcy management of the Railroad. Assuming *arguendo* that the contemplated discovery would establish a link between the Pennco Board and the alleged malefactors, the plaintiff is still faced with the problem of excusing a demand upon the shareholders.

The prerequisites to a derivative suit include not only a demand upon the board of directors but, in appropriate

cases, a demand upon the shareholders as well, see *Hawes v. Oakland*, 104 U.S. 450 (1881); Rule 23.1 Fed. R. Civ. P.; Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 Harv. L. Rev. 746 (1960). Plaintiff contends that a demand upon the shareholders of Pennco would be futile because all of the voting (common) stock is controlled by the Railroad. The fallacy of plaintiff's contention becomes clear when it is remembered that as a result of the bankruptcy the term "Railroad" has become synonymous with the term "Trustees of the Railroad." In reality, the plaintiff is asking this court to conclude that a demand upon four readily accessible trustees, appointed by and under the supervision of the United States District Court for the Eastern District of Pennsylvania, would be futile. In order to reach such a conclusion three facts must be assumed: first, that the court-appointed trustees have the power to control the decisions of the Pennco Board; second, that the trustees will use this power to prevent the Pennco Board from commencing a direct suit to recover for the wrong allegedly done to the corporation; and third, that in refusing to bring the suit the Pennco Board and the Trustees of the Railroad would be acting negligently or wrongfully and not as a result of a business judgment. There is no evidence before the court upon which to base such assumptions. Accordingly, the first and third counts of the complaint should be dismissed for failure to make a demand as required by Rule 23.1 Fed. R. Civ. P.

II. The Representative Counts

Defendants move to dismiss the fifth and sixth counts of the complaint for failure to state a cause of action for which direct relief can be granted to the plaintiff. Defen-

dants contend that the rights asserted are corporate in nature; and that, therefore, plaintiff does not have a cause of action for direct recovery. The fifth and sixth counts allege essentially the same transactions relied upon in the derivative counts. Plaintiff contends that as a result of the loan transactions the market price of Pennco stock has been substantially reduced, and that Pennco has been unable to pay dividends.

Although in certain instances a single injury may give rise to both corporate and individual actions, *see, e.g., Dann* v. *Studebaker-Packard Corp.*, 288 F.2d 201 (6th Cir. 1961); *Snyder* v. *Epstein*, 290 F. Supp. 652 (E.D. Wisc. 1968); *Brown* v. *Bullock*, 198 F. Supp. 207 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961); *Hammer* v. *Werner*, 239 App. Div. 38 (2d Dep't) 265 N.Y.S. 172 (1933); 13 W. Fletcher, *Corporations* §5921 (Perm. ed. 1970), it is well established that an action to recover for a reduction in the monetary value of stock is a corporate and not an individual suit, *e.g., Brictson* v. *Woodrough*, 164 F.2d 107 (8th Cir. 1947); *Green* v. *Victor Talking Machine Co.*, 24 F.2d 378 (2d Cir. 1928); *Weiner* v. *Winters*, 50 F.R.D. 306 (S.D.N.Y. 1970); *Henry* v. *General Motors Corp.*, 236 F. Supp. 854 (N.D.N.Y.), *aff'd*, 339 F.2d 887 (2d Cir. 1964).

Borak v. *J. I. Case Co.*, 317 F.2d 838 (7th Cir. 1963), *aff'd*, 377 U.S. 426 (1964), relied upon by the plaintiff is clearly inapposite. The *Borak* case did not involve a dimunition in corporate assets with a resulting drop in the monetary value of stock, but a reduction in individual proportionate ownership of a corporation as a result of the issuance of new shares in violation of preemptive rights. The distinction between these cases is clear. Preemptive rights involve "a stockholder['s] . . . *personal right* to exercise a relative voice in the control and man-

agement of the corporation." (Emphasis added.) *Horowitz* v. *Balaban*, 112 F. Supp. 99, 101 (S.D.N.Y. 1949). However, "even a sole shareholder has no independent right which is violated by trespass upon or conversion of the corporation's property." *Green* v. *Victor Talking Machine Co., supra* at 380. The primary consequence of the allegedly fraudulent loan transactions was the incurrence of a $50,000,000 debt by Pennco; any subsequent injury to the shareholders by virtue of a dimunition in the value of corporate stock was secondary, and does not give rise to a direct stockholder action.

In addition to the alleged reduction in the value of Pennco stock, plaintiff contends that as a result of the loan transactions Pennco has failed to pay dividends, thereby injuring the shareholders. Although it is clear that the declaration of a dividend creates a debtor-creditor relationship between a corporation and its shareholders giving rise to a direct shareholder action for payment, *Gordon* v. *Elliman*, 306 N.Y. 456, 119 N.E.2d 331 (1954); 13 W. Fletcher, *Corporations* §5922 (Perm. ed. 1970), the right of a shareholder to direct relief in an action to compel the declaration of a dividend is at best tenuous.

The declaration of a dividend is initially a matter within the sound business discretion of the board of directors, subject to limitation by applicable statutes and certifiate of incorporation or by-law provisions. *New York, Lake Erie & W. R. R.* v. *Nicklas*, 119 U.S. 296 (1886). *See generally* 11 W. Fletcher, *Corporations* §5325 (Perm. ed. 1970). Where earned dividends are not declared because of bad faith or dishonesty on the part of the board of directors, a derivative action is appropriate. *Gordon* v. *Elliman, supra*. However, it appears that for a direct shareholder action to lie the corporation must be under a "contractual obli-

gation" to pay dividends at fixed rates and times. Thus, in *Boardman* v. *Lake Shore & Mich. S. Ry.*, 84 N.Y. 157 (1881) where the terms of the stock certificate guaranteed annual dividend payments out of profits at a specified rate, an individual right enforceable by a direct shareholder action was created, *accord, Koppel* v. *Middle States Petroleum Corp.*, 272 App. Div. 790, 69 N.Y.S.2d 784 (1st Dep't 1947).

In the opinion of the court, the plaintiff is not afforded that absolute right to dividends out of profits that gives rise to a direct action.[4] Moreover, the circumstances of the instant case do not fundamentally involve a refusal by a recalcitrant board of directors to declare dividends out of accumulated earnings. Rather, the injury is to the profit potential of Pennco itself, by reason of the allegedly fraudulent loan transactions. The paramount injury being to the corporation, the appropriate vehicle for recovery is either a direct corporate action or a derivative suit in the right of the corporation.

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[4] The dividend rights of preferred stock as set forth in the Agreement of Merger dated July 24, 1964 are:

(1) Before any dividends (other than dividends payable in stock ranking junior to the Preferred Stock as to dividends or on liquidation shall be declared or paid or set apart for payment, the holders of shares of Preferred Stock shall be entitled to receive cash dividends, when and as declared by the Board of Directors, at the annual rate of 4⅝% of the par value of the Preferred Stock, and no more, payable quarterly on the fifteenth day of January, April, July, and October in each year to holders of record on such respective dates, not exceeding forty days preceding such dividend payment dates, as may be determined by the Board of Directors in advance of the payment of each particular dividend. Such dividends with respect to each share of Preferred Stock shall be cumulative from the date of issuance thereof. Accruals of dividends shall not bear interest.

In accordance with the reasons set forth above, the defendants' motion to dismiss the complaint is granted.

So Ordered.

Dated: New York, New York
July 26, 1972.

L. P. GAGLIARDI.
U.S.D.J.